



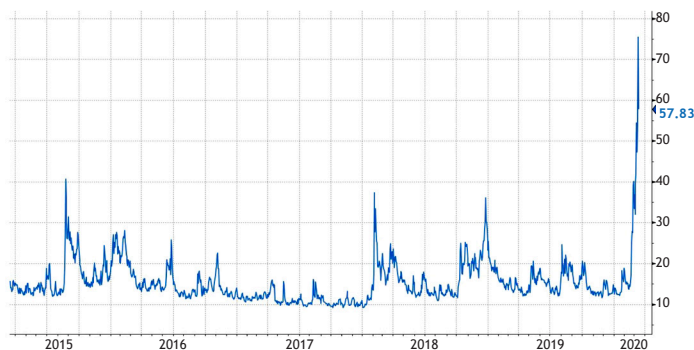
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## Current Environment

Following a near-idyllic environment for financial markets last year, resulting in a rare showing of positive returns across all major asset classes, the new decade has forced investors to confront a sudden move to extreme volatility, fear and for some, a shift in focus from wealth creation to capital preservation. The two charts below illustrate how the volatility in equity and bond markets have turned and how they compare to previous periods of market and economic stress. The VIX (chart 1) or the ‘fear’ gauge measures the implied volatility in equity market while MOVE (chart 2) is a similar indicator for bonds.

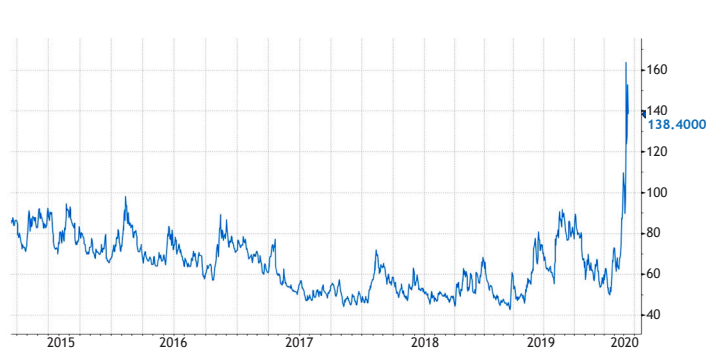
**Chart 1 – VIX Index**

(Chicago Board Options Exchange Volatility Index) 1 YR DAILY



**Chart 2 – MOVE Index**

(ICE BofA MOVE Index) 1 YR DAILY



The sequence of events resulting in this radically altered environment includes the following developments:

- The novel coronavirus and resulting disease, Covid-19, has now been officially declared a pandemic by the World Health Organization. The outbreak of the virus in Wuhan, China was identified early in the year and has now spread to 112 countries. The outbreak is in the early stages in North America. Initially, the impact on global markets was similar to a supply shock as global supply chains were disrupted and trade slowed dramatically. Subsequent shutdowns initially in China, Italy and increasingly across more geographies will extend this impact and result in a significant demand shock in coming economic data. Again, this response is in the early stages in North America.
- In a subsequent development a three year agreement between OPEC and Russia to curtail oil production was dissolved in an acrimonious fashion with both parties ramping up production. Excess supply in an environment of weak global demand has resulted in a 50% drop in oil prices since the year began, a further significant shock to oil producing regions including western Canada and heavily indebted shale oil producers in the US. Credit concerns have risen for energy stocks and many in the leisure, hospitality and travel industries.

- These two shocks have been met by an aggressive easing in monetary policy with a 150 basis point cut in administered rates by the Federal Reserve and 100 basis points by the Bank of Canada, with more stimulus likely to come. To date the fiscal policy response in both countries has been muted with \$1 billion in Canada and \$8.3 billion in the US. A significantly larger response is likely to come.
- The impact of recent developments on global GDP will begin to emerge in March data, resulting in lower Q1 GDP and the full weight will become evident with the release of Q2 data across various regions. As to whether this triggers a technical recession in Canada, defined as two quarters of negative GDP, will depend on the magnitude of the short term response and how long it takes to stabilize the rate of new infections. Epidemiologists suggest China may serve as useful model in this regard. New cases in China have dramatically fallen (if the numbers are accurate) and the country is now trying to restart its economy. This would suggest that the situation in Canada may be six to eight weeks behind, which in turn implies that the data will get much worse before it gets better.

## Market Reaction

After 11 years, most global equity markets have entered bear market territory with corrections exceeding 20%. The correction from late February has locked in the largest bull market in history (March 2009 through February 2020) for the S&P 500. The counter to the equity market selloff has been a huge rally in the fixed income markets as yields dropped across the curve to new low levels. The FTSE Canada Universe bond index has advanced 4.1% year to date with 10 year yields falling from 1.70% on December 31, 2019 to a recent low level of 0.23% on March 9, 2020, and the index is up over 9% on a one year time frame. Corporate credit and high yield securities have been punished as spreads have widened dramatically in sync with the equity market selloff.

Stretched valuations in equity markets had been a concern for some time and had become a significant obstacle to long term returns. Corporate credit and high yield spreads had also tightened into levels only seen prior to the 2008 great financial crisis. Our asset mix process has steadily reduced equity exposure below normal levels, moved to hold higher than normal cash balances and had adopted a more defensive tilt within equity and fixed income portfolios. While directionally correct, this has only reduced, not eliminated the impact on client portfolios.

The market correction over the past three weeks has resolved this valuation concern; however, the largest uncertainty is how long the virus will continue to negatively impact the global economy and investor confidence. As well, liquidity always becomes more challenging during times of heightened uncertainty as investors are less willing to implement large shifts in either direction.

Is it time to buy equities? Picking market tops and bottoms during periods of extreme volatility is a challenge. The recent market correction has caused our asset mix to shift dramatically and we are now well below our targets in equities and well above in bonds, and our process suggests a cautious and disciplined rebalancing back to targets. A classic quote from Warren Buffet regarding his long term success sums it up quite succinctly: “We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.” The equity and credit markets now offer significantly better value and cautiously adding risk now through asset allocation and security selection should prove to add value over time.

Asset Class Returns as of March 12, 2020

